

Quality of Earnings

Where Value Is Quietly Preserved or Lost

What diligence teams actually analyze in SaaS, Compliance & ARM Services

1. Normalized Earnings

Separating durable earnings from noise.

- EBITDA & adjusted EBITDA bridge
- One-time and non-recurring items
- Owner & related-party normalization
- Run-rate vs reported results

Valuation impact: Smaller normalized base and reduced leverage

2. Revenue Quality & Sustainability

Whether revenue is real, recurring, and durable.

- ASC 606 methodology
- Recurring vs services separation
- Deferred revenue tie-outs
- Churn and concentration

Valuation impact: Multiple compression or earn-outs

3. Contracts & ARR Integrity

How well revenue is supported by paper.

- Executed customer contracts
- ARR to contract reconciliation
- Non-standard termination or refund terms
- Change-of-control provisions

Valuation impact: Pricing adjustments and indemnities

4. Gross Margin & Cost Structure

Whether margins scale or mask problems.

- Margin by revenue stream
- Services margin normalization
- Labor allocation (COGS vs OpEx)
- Hosting and vendor costs

Valuation impact: EBITDA and margin reclassification

5. Expense Integrity

Whether expenses reflect economic reality.

- Payroll and headcount completeness
- Commission and bonus accruals
- Benefits and payroll taxes
- G&A; scalability

Valuation impact: Downward EBITDA adjustments

6. Working Capital & Cash Flow

How earnings convert to cash.

- Net working capital definition
- Deferred revenue treatment
- AR aging and collectability
- Cash flow vs EBITDA

Valuation impact: Purchase price true-ups

7. Tax & Statutory Exposure

Liabilities that do not live in EBITDA.

- Sales and use tax nexus
- SaaS vs services taxability
- Payroll tax compliance
- Historical lookback exposure

Valuation impact: Escrows, indemnities, price reductions

8. Labor, Benefits & Contingent Liabilities

Often under-reserved, often debt-like.

- Employee vs contractor classification
- Overtime and wage compliance
- PTO and benefit reserves
- IBNR and claims exposure

Valuation impact: Debt-like adjustments and escrows

9. Litigation & Regulatory Risk

Where historical practices resurface.

- Active and threatened litigation
- Regulatory inquiries (CFPB, AGs)
- Loss contingency methodology
- Insurance coverage gaps

Valuation impact: Price reductions and delayed closes

10. Financial Controls & Reporting

Whether the numbers can be trusted.

- Monthly close discipline
- Balance sheet reconciliations
- System integrations
- KPI to GL tie-outs

Valuation impact: Extended diligence and conservative pricing

11. Ownership, IP & Records

Clean structure behind the business.

- Cap table accuracy
- Equity grants and vesting
- IP assignments
- Centralized contract records

Valuation impact: Closing delays and legal risk

12. Forecast Credibility & Pro Forma

Confidence in forward earnings.

- Historical forecast accuracy
- Pipeline and backlog quality
- Pricing discipline
- Post-deal cost assumptions

Valuation impact: Reduced reliance on projections

The quiet conclusion

Quality of Earnings is not a checklist. Treated mechanically, it becomes a distraction. Handled routinely, it becomes confirmation—not discovery. Founders who maintain discipline across these areas preserve leverage when it matters most.